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In the Supreme Court of the United States

OCTOBER TERM, 1976

UNITED STATES OF AMERICA, PETITIONER

v.

CONSUMER LIFE INSURANCE COMPANY

FIRST RAILROAD & BANKING COMPANY OF GEORGIA, PETITIONER

v.

UNITED STATES OF AMERICA

UNITED STATES OF AMERICA, PETITIONER

v.

PENN SECURITY LIFE INSURANCE COMPANY

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS AND THE UNITED STATES CAURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES

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INDEX

	Page
Opinions below	2
Jurisdiction	2
Questions presented	3
Statutes and regulations involved	4
Statement:	6
I. No. 75–1221	6
1. Treaty I	8
2. Treaty II	10
II. No. 75–1260	17
III. No. 75–1285	23
Summary of argument	30
Argument:	34
An insurance company does not qualify for taxation as a life insurance company unless its life insurance reserves exceed 50 percent of the total reserves attributable to policies upon which it bears the ultimate insurance risk	34
A. Introduction	34
B. The language of Section 801(c) supports inclusion of the accident and health reserves in the taxpayers' "total reserves"	37
C. The 50 percent reserve ratio test of Section 801(a) rests upon the principle that insurance reserves are attributable to the company that assumes the corresponding risks	42

216-901—76——1

Argument—Continued

Page

D. The reinsurance arrangements in these cases did not shift the accident and health reserves from the "total reserves" of the taxpayer companies to the other companies that were parties to the arrangements because the taxpayers bore the ultimate risk on the accident and health policies ---------- 51

E. The applicable state law confirms that the accident and health insurance reserves are includable in the taxpayers' total reserves---- 66

Conclusion ---------- 75

CITATIONS

Cases:

Alinco Life Ins. Co. v. *United States*, 373 F. 2d 336---------- 47, 61

Commissioner v. *Estate of Bosch*, 387 U.S. 456 ---------- 67

Colonial Surety Co. v. *United States*, 178 F. Supp. 600---------- 40

Commissioner v. *Hansen*, 360 U.S. 446---- 57

Commissioner v. *Monarch Life Ins. Co.*, 114 F. 2d 314---------- 47

Corliss v. *Bowers*, 281 U.S. 376---------- 35

Economy Finance Corp. v. *United States*, 501 F. 2d 466, certiorari denied, 420 U.S. 947, rehearing denied, 421 U.S. 922, motion for leave to file a second and untimely petition for rehearing pending, No. 74–701---------- *passim*

Gregory v. *Helvering*, 293 U.S. 465------ 36

Cases—Continued

Page

Helvering v. *Clifford*, 309 U.S. 331------- 35

Helvering v. *Horst*, 311 U.S. 112--------- 35

Helvering v. *Illinois Ins. Co.*, 299 U.S. 88-- 60

Helvering v. *LeGierse*, 312 U.S. 531------ 31, 43

Jefferson Standard Life Ins. Co. v. *United States*, 408 F. 2d 842, certiorari denied, 396 U.S. 828---------- 42

Jones v. *United States*, 531 F. 2d 1343---- 65

King v. *Order of Travelers*, 333 U.S. 153-- 67

Kinsey v. *Commissioner*, 477 F. 2d 1058--- 65

Knetsch v. *United States*, 364 U.S. 361---- 35

Lucas v. *Earl*, 281 U.S. 111---------- 35

McCoach v. *Insurance Co. of North America*, 244 U.S. 585---------- 60

Minnesota Tea Co. v. *Helvering*, 302 U.S. 609---------- 55

National Protective Ins. Co. v. *Commissioner*, 128 F. 2d 948, certiorari denied, 317 U.S. 655---------- 47

New World Life Insurance Co. v. *United States*, 26 F. Supp. 444, affirmed, 311 U.S. 620---------- 47

New York Life Ins. Co. v. *Edwards*, 271 U.S. 109---------- 60

Superior Life Insurance Co. v. *United States*, 462 F. 2d 945---------- 48, 56

United States v. *Atlas Life Ins. Co.*, 381 U.S. 233---------- 42

United States v. *Basye*, 410 U.S. 441------ 35

United States v. *Estate of Grace*, 395 U.S. 316 ---------- 36

United States v. *Jackson Oldsmobile, Inc.*, 371 F. 2d 808---------- 65

Cases—Continued
Page
West v. *A.T. & T. Co.*, 311 U.S. 223 67
Williams v. *Union Central Life Ins. Co.*, 291 U.S. 170 44
Statutes, regulations and rule:
Internal Revenue Code of 1954 (26 U.S.C.):
Section 801 ..... 4, 14, 32, 60, 66
Section 801(a) ..... *passim*
Section 801(a)(1) 4
Section 801(a)(2) 4, 48
Section 801(b) 4, 61
Section 801(b)(1) 4
Section 801(c) ..... *passim*
Section 801(c)(1) 5, 38, 41
Section 801(c)(2) ..... *passim*
Section 801(c)(3) ..... *passim*
Sections 801–820 42
Section 802(b) 43
Section 802(b)(2) 43
Section 810 40
Section 810(c)(2) 40–41
Section 815 43
Section 831 ..... 14, 43, 45
Section 832 ..... 14, 43, 45
Section 1504(b)(2) 17
Revenue Act of 1918, c. 18, 40 Stat. 1057, Section 234(a)(10) 42
Revenue Act of 1921, c. 136, 42 Stat. 227:
Section 242 ..... 46, 48
Sections 242–247 42
Ariz. Rev. Stat. Ann. (1956):
§ 20–103 69
§ 20–104 69

Statutes, regulations and rules—Continued
Ariz. Rev. Stat. Ann. (1956)—Continued
Page
§ 20–261 74
§ 20–501(5) 70
§ 20–501(7) 70
§ 20–501(9 ..... 70, 71
§ 20–506 ..... 69, 74
Georgia Code Ann. (1935):
§ 56–102 69
§ 56–103 69
§ 56–413 73
§ 56–413(3) 74
§ 56–901 71
§ 56–906 ..... 69, 74
§ 56–908 60
Mo. Stat. Ann. (1968):
§ 376.246 ..... 73, 74
§ 376.410 ..... 69, 72
Treasury Regulations on Income Tax (26 C.F.R.):
Section 1.801–3(e) 5–6, 59, 60
Section 1.801–5(b) 6, 66
Court of Claims Rule 131(c) 2, 3
Miscellaneous:
A Preliminary Statement of the Facts and Issues with Respect to the Federal Taxation of Life Insurance Companies, Hearings on Federal Taxation of Life Insurance Companies before a Subcommittee of the House Committee on Ways and Means, 83d Cong., 2d Sess. (1955) 42
Hearings on H.R. 8245, Internal Revenue, before the Senate Committee on Finance, 67th Cong., 1st Sess. (1921) 46

Miscellaneous—Continued

	Page
Hammond, *Insurance Accounting Fire and Casualty* (2d ed.. 1965)	40, 72
H.R. Rep. No. 34, 86th Cong., 1st Sess. (1959)	42, 44
National Association of Insurance Commissioners, *Examiners Handbook* (1970 ed.)	52, 74
Reinarz, *Property and liability Reinsurance Management,* (1969 ed.)	75
S. Rep. No. 291, 86th Cong., 1st Sess. (1959)	44

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No. 75-1221

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OPINIONS BELOW

No. 75–1221. The recommended decision of the trial judge (Pet. App. A 1a–66a) is not reported. The findings of fact and opinion of the Court of Claims (Pet. App. B 67a–129a) are reported at 524 F. 2d 1167.

No. 75–1260. The memorandum opinion of the district court (Pet. App. B 8a–18a) is not reported. The opinion of the court of appeals (Pet. App. A 1a–7a) is reported at 514 F. 2d 675.

No. 75–1285. The opinion of the Court of Claims (Pet. App. 1a–60a), incorporating the opinion of the trial judge with minor changes and some additions, is reported at 524 F. 2d 1155.

JURISDICTION

No. 75–1221. The judgment of the Court of Claims was entered on October 22, 1975 (Pet. App. B 67a, 129a).[1] By order dated January 15, 1976, the Chief Justice extended the time for filing a petition for a writ of certiorari to and including March 20, 1976. The petition was filed on February 25, 1976, and was granted on May 24, 1976. The jurisdiction of this Court rests on 28 U.S.C. 1255(1).

No. 75–1260. The judgment of the court of appeals was entered on June 11, 1975 (Pet App. A 1a–7a), and a petition for rehearing was denied on October 8, 1975 (Pet. 2). By order dated December 12, 1975, Mr. Justice Powell extended the time for filing a

[1] The amount of the judgment will be determined in further proceedings under Rule 131(c) of the Court of Claims (Pet. App. B 129a).

petition for a writ of certiorari to and including March 6, 1976. The petition was filed on March 5, 1976, and was granted on May 24, 1976. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

No. 75–1285. The judgment of the Court of Claims was entered on October 22, 1975 (Pet. App. 1a, 60a).[2] By order dated January 15, 1976, the Chief Justice extended the time for filing a petition for a writ of certiorari to and including March 20, 1976. The petition was filed on March 9, 1976, and was granted on May 24, 1976. The jurisdiction of this Court rests on 28 U.S.C. 1255(1).

QUESTION PRESENTED

Section 801(a) of the Internal Revenue Code of 1954 defines a "life insurance company" as an insurance company whose life insurance reserves comprise more than 50 percent of its "total reserves," as that term is defined in Section 801(c).

The question presented is whether an insurance company, which bears the ultimate insurance risk on accident and health policies transferred under reinsurance arrangements with other companies, is required for federal tax purposes to include in its total reserves the reserves attributable to such non-life policies so as to disqualify it from the preferential tax treatment accorded to a life insurance company; or whether such non-life reserves should be attributed to the other com-

[2] The amount of the judgment will be determined in further proceedings under Rule 131(c) of the Court of Claims (Pet. App. 60a).

panies that temporarily hold the single payment premiums on the policies and later pay them (less claims paid) over to the company bearing the insurance risk, retaining only a commission for their administrative services.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 801 [as amended by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112]. DEFINITION OF LIFE INSURANCE COMPANY.

(a) Life Insurance Company Defined.—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves, comprise more than 50 percent of its total reserves (as defined in subsection (c)).

(b) Life Insurance Reserves Defined.—

(1) In general.—For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or mor-

bitity tables and assumed rates of interest, and

(B) which aer set aside to mature or liquidate, either by payment or reinsurance, future unaccrused claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

* * * * *

(c) Total Reserves Defined.—For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

The term "total reserves" does not include deficiency reserves (within the meaning of subsection (b)(4)).

* * * * *

Treasury Regulations on Income Tax (26 C.F.R.):

§ 1.801-3 Definitions.

* * * * *

(e) Unearned premiums.—The term "unearned premiums" means those amounts which

shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

* * * * *

§ 1.801–5 Total reserves.

* * * * *

(b) Reserves required by law defined.—For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policy holders or beneficiaries.

* * * * *

STATEMENT

I. No. 75–1221

A. Respondent Consumer Life Insurance Company is a wholly-owned subsidiary of Southern Discount Company. At the time of respondent's incorporation in 1957 under the Insurance Code of Arizona and thereafter, its parent, Southern Discount, was engaged in the consumer finance business in Georgia and several other states. When Southern Discount made a loan, its borrowers usually purchased term life and term accident and health ("A&H") insurance in order to provide for the payment of the loan in the event of the borrower's death or disability (Pet. App. B 68a–69a, 94a–95a).

This type of insurance, known as credit life and credit A&H insurance, is generally coextensive in term and coverage with the term and amount of the loan, and provides for the full payment of the loan balance in the event of the borrower's death or for the payment of monthly installments on the loan in the event of his disability resulting from accident or sickness. The premiums for such insurance are generally payable by the borrower as a single premium for the full period of coverage (Pet. App. B 68a–69a, 94a–95a).

The Georgia law under which Southern Discount was incorporated prohibited it from issuing credit life and credit A&H insurance itself. However, it was permitted to act as a sales agent for qualified insurance companies issuing such policies. Prior to its formation of respondent, Southern Discount acted as a sales agent for American Bankers Life Assurance Company, a Florida corporation which issued credit life and credit A&H policies to Southern Discount's debtors. Under its arrangement with American Bankers, Southern Discount received a commission of approximately 50 percent of the premiums paid by the

policyholders, which was the maximum commission rate allowed by law (Pet. App. B 69a).

1. TREATY I

In order to obtain a greater portion of the profits from the credit insurance issued to its borrowers, Southern Discount organized respondent in 1957 for the purpose of underwriting the credit life and credit A&H insurance for its borrowers. Under Georgia law, respondent's initial $38,000 capitalization was insufficient to enable it to act as a direct insurer. However, because of its status as an insurance company chartered in Arizona, respondent was permitted to reinsure risks under policies issued by other companies authorized to issue insurance directly. As a result, on June 28, 1957, respondent entered a reinsurance agreement or treaty ("Treaty I") with American Bankers under which it reinsured the risks under all credit life and credit A&H policies thereafter issued by American Bankers to individuals obtaining loans from Southern Discount and its subsidiaries (Pet. App. B 69a–70a, 95a–99a).

The Treaty I contract specifically provided that respondent agreed to reimburse American Bankers "for all losses actually paid on [both] Life policies and * * * Health and Accident policies * * *" (Pet. App. B 114a). Respondent therefore freely conceded in the court below (A. 130–133) that under the Treaty I arrangement, it assumed the entire insurance risk on both the credit life and the credit A&H policies. In exchange for assumption of the risks under these

policies, respondent received 87½ percent (subsequently increased to 90½ percent) of the premiums collected by American Bankers (Pet. App. B 70a–71a, 113a–114a).

Pursuant to Treaty I, American Bankers collected the premiums in full when it issued the policies, and paid all claims under the policies. Each month American Bankers remitted to respondent its full share of all life insurance premiums received by it during the previous month. However, with respect to the credit A&H premiums, American Bankers remitted to respondent each month only the "earned premiums," *i.e.*, that portion of the premiums collected during the prior month that was ratably allocable to the A&H coverage for the prior month.[3] The remaining portion of respondent's share of A&H premiums was remitted monthly on a pro rata basis over the balance of the period of coverage. Thus, while respondent received its share of life insurance premiums almost immediately upon issuance of the policies, it received its share of the A&H premiums only after the periods of coverage attributable to the premiums had expired (Pet. App. B 70a—71a, 110a–117a).

The agreement further provided that respondent would maintain reserves with respect to the credit life insurance and that American Bankers would

[3] The trial judge noted (Pet. App. B 102a–103a) that the established method in the insurance industry for computing accident and health insurance reserves is on the basis of the portion of premiums that remains "unearned" on the reserve valuation date. The "unearned premium reserve" is equal to the portion of the premiums which is attributable to periods of future coverage.

maintain reserves for "unearned premiums on the A&H insurances." Finally, the agreement could be terminated by either party on 30 days notice. However, in the event of termination, the agreement provided that it was to "continue to apply to all policies reinsured hereunder before such termination becomes effective" (Pet. App. B 70a–71a, 110a–117a).

2. TREATY II

By 1962, respondent's capital had increased sufficiently to enable it to qualify as a direct insurer under Georgia and North Carolina law. As a result of this change in respondent's status, on April 18, 1962, American Bankers and respondent entered into a second reinsurance agreement ("Treaty II") under which their roles were purportedly reversed. Pursuant to Treaty II, respondent became the primary insurer of the credit life and A&H policies issued to Southern Discount's borrowers. American Bankers agreed to reinsure 80 percent of the liability under each A&H policy (but none of the life insurance) issued by respondent (Pet. App. B 72a–73a, 99a).

Treaty II provided that respondent was to remit quarterly to American Bankers the premiums collected on the ceded 80 percent share of the A&H insurance less its own tentative commission of 50 percent. The agreement further provided that American Bankers would subsequently return to respondent a quarterly rebate or "experience refund" equal to the total premiums ratably allocable to the insurance coverage for the prior quarter, less the sum of: (1) the

50 percent tentative commission previously retained by respondent with respect to such "earned" premiums, (2) three percent of gross earned premiums allocable to such quarter, and (3) the sum of all claims paid during the quarter by American Bankers on such policies. If the sum of these three reductions exceeded the premiums for any quarter, the excess would be carried over to the succeeding quarter and charged against the experience refund for that quarter (Pet. App. B 72a–74a, 120a–121a).

As of December 31, 1964, Treaty II was amended to provide that any negative carry-forward arising from loss experience for a particular quarter would be dropped after 20 quarters, if it was not absorbed by that time. The effect of this amendment was that American Bankers would in all events receive its 3 percent commission on premiums on the ceded A&H coverage, and would incur no loss unless it experienced average claims on these policies exceeding 47 percent (50 minus 3) of premiums over a period of more than five consecutive years. Conversely, there were no circumstances under which American Bankers' profit under Treaty II could have exceeded its three percent commission (Pet. App. A 46a–48a, Pet. App. B 72a–74a, 128a).

The loss experience on A&H insurance under Treaty I had ranged from 28 to 30 percent of premiums paid. At the time of the 1964 amendment, the loss experience on A&H insurance covered by Treaty II during the three years it had been in force was only 18 percent of premiums paid. Thus, the

216-901—76——2

trial judge found that the likelihood that loss experience would run so high as to jeopardize American Bankers' commission was so remote as to be negligible, and that the parties knew this to be the fact (Pet. App. A 47a—48a; Pet. App. B 74a).

B. During 1958–1964, respondent reported on the annual statements it was required to file with the Arizona and Georgia insurance authorities that it received income equal to the full amount of life insurance premiums and it reported the life insurance reserves for such policies prescribed under the appropriate actuarial tables. However, with respect to the A&H insurance respondent reinsured with American Bankers under Treaty I, respondent reported as income only the portion of premiums paid to it by American Bankers, which was attributable to the expired portions of the terms of the policies (Pet. App. B 71a–72a).

Respondent did not report, either as income or as an asset, any of the A&H premiums attributable to the unexpired portions of the terms of those non-life policies, and it reported no reserves whatsoever with respect to the A&H policies. Similarly, respondent reported no reserves on the 80 percent portion of the A&H insurance that was ceded to American Bankers under Treaty II. American Bankers, on the other hand, maintained unearned premium reserves with respect to both the A&H insurance reinsured by respondent under Treaty I and the A&H insurance ceded to it by respondent under Treaty II (A. 226; Pet. App. B 72a).

Respondent was subjected to a number of examinations during 1958–1964 by the insurance departments of Arizona, Georgia and other states in which it did business. No state regulatory authority took exception to its failure to maintain reserves with respect to the A&H coverage under Treaty I and II (Pet. App. B 71a–72a, 74a–76a, 101a–102a, 105a–107a). However, the Senior Actuary and Chief Examiner of the Georgia Insurance Department testified that respondent's failure to report in its annual statement the unearned premium A&H reserves under both Treaties was permitted "unwittingly" by the Georgia authorities (A. 239) and was in fact contrary to that state's policy (A. 211–213, 215, 221–226, 232–233, 240, 241–242, 256–259). In his view, Treaty II was not a valid reinsurance agreement because respondent did not transfer any risk (A. 225).[4] Similarly, the Arizona examiner who had conducted respondent's triennial examination for that state for 1963 testified that respondent should have been required to maintain the unearned premium A&H reserves under Treaty II, but had been permitted to exclude them from its reserves because it was the first time that the Arizona

[4] The Georgia official stated that under Treaty I respondent should have been required to establish an asset for "premium[s] in the course of collection" and a corresponding liability for unearned premium reserves for the A&H coverage issued directly by it. He further testified that under Treaty II respondent should not have been permitted to eliminate from its annual statement the unearned premium reserves for the portion of the A&H coverage ceded to American Bankers because respondent had not transferred any risk to American Bankers (A. 169, 211–212, 215, 222–223, 232, 239, 240, 241–242, 256–259).

authorities had encountered such an arrangement (A. 266–268).

Respondent prepared its federal income tax returns for the years 1958–1964 in accordance with its methods of reporting reserves on its annual statements filed with the various state insurance authorities. For each of the years in question (1958–1964), respondent took the position on its tax returns that it qualified for the preferential tax treatment accorded to a "life insurance company" as defined by Section 801(a) of the Internal Revenue Code because its reported life insurance reserves exceeded 50 percent of its total reserves as reported on its annual statements (Pet. App. B 76a–77a).

On audit, the Commissioner of Internal Revenue determined that the unearned premium reserves on the A&H insurance under both Treaty I and II should have been included in respondent's total reserves. When the A&H reserves were taken into account, respondent failed to qualify as a "life insurance company" under the Section 801(a) definition for its taxable years 1958–1960, 1962–1964, because its non-life insurance reserves exceeded 50 percent of its total reserves. The Commissioner thereupon recomputed respondent's tax liability and determined deficiencies on the ground that respondent was an ordinary insurance company taxable under Sections 831 and 832 of the Code and not taxable as a life insurance company as defined by Section 802 of the Code (Pet. App B 92a–94a).

C. Respondent brought this refund suit for $351,393.88 in the Court of Claims (A.6). In its claim for refund, respondent had conceded that one of the reasons for entering into the reinsurance agreement was "to minimize its tax liability" (A. 27). At the trial, the president of Southern Discount acknowledged to the trial judge "that assumption of the risk is the basic hallmark" of both insurance and reinsurance (A. 40). He also conceded that under Treaty I, Consumer Life assumed as reinsurer the same degree of risk under the ceded A&H insurance as it did with respect to the credit life insurance (A. 47–48), and that under both treaties, Consumer Life was obliged to bear all losses because they were paid out of the premiums that would otherwise have been earned by it (A. 51–57).

The trial judge's recommended decision upheld the Commissioner's determination that respondent was required to treat the reserves attributable to the A&H insurance as part of its total reserves and, therefore, that it did not qualify as a "life insurance company" under Section 801(a) of the Code. The trial judge premised his conclusion on the ground that, with respect to both Treaty I and II, respondent was required under Georgia and Arizona law to maintain the reserves attributable to the A&H insurance so that such reserves were includable in respondent's total reserves as "other insurance reserves required by law" under Section 801(c)(3) of the Code. As a result, the trial judge found it unnecessary to reach

the government's further contention that respondent was required to include in its total reserves the A&H reserves as "unearned premiums" under Section 801 (c)(2) of the Code (Pet. App. A 14a–23a).

With one judge dissenting, the Court of Claims disagreed with the recommended decision of the trial judge. In accordance with its decision on the same day in *Penn Security Life Insurance Co.* v. *United States* (No. 75–1285), the court held that the A&H reserves could not be included in respondent's total reserves as "unearned premiums" under Section 801(c)(2) of the Code because American Bankers was in physical possession of the unearned portion of the premiums paid in advance on the A&H coverage in question under both Treaty I and Treaty II (Pet. App. B 81a). In rejecting the trial judge's conclusion that respondent was required by Georgia and Arizona law to include the A&H reserves in its total reserves, the majority relied upon the fact that respondent's method of reporting its income and reserves did not result in the institution of any action by the Georgia and Arizona insurance authorities (Pet. App. B 81a–92a).

The dissenting judge adhered to the views expressed in his dissent in *Penn Security* that the A&H reserves should be included in respondent's total reserves as "unearned premiums" under Section 801(c)(2) of the Code because "[respondent] has arranged to have [such reserves] ostensibly carried for it by others, though in reality it bears the risk of loss itself" (524 F. 2d at 1167). In so concluding, the dissenting judge agreed with *Economy Finance Corp.* v. *United States,*

501 F. 2d 466, (C.A. 7), certiorari denied, 420 U.S. 947, rehearing denied, 421 U.S. 922, motion for leave to file a second and untimely petition for rehearing pending , No. 74–701, which held, on facts essentially identical to those of Treaty I, that the company's failure to include in "total reserves" the reserves for A&H policies on which it bore the actual insurance risk "completely frustrates the purpose Congress ha[d] in mind in prescribing the [50 percent] test [of Section 801(a)]" (524 F. 2d at 1167) (Pet. App. B 92a).

II. No. 75–1260

A. Petitioner First Railroad & Banking Company of Georgia was the common parent of a group of affiliated corporations, for which it filed consolidated federal income tax returns for the years 1961 through 1964. During that period, petitioner excluded from these consolidated returns the income of a second-tier subsidiary, First of Georgia Life Insurance Company, on the ground that Georgia Life qualified as a "life insurance company" under Section 801(a) of the Code and therefore could be excluded from the "affiliated group" for consolidated return purposes pursuant to Section 1504(b)(2) (Pet. App. B 8a–9a).

Georgia Life was primarily engaged in issuing credit life and credit accident and health (A&H) insurance to borrowers from credit companies. Such insurance was generally coextensive in term and coverage with the term and amount of the underlying indebtedness, and provide a means for satisfying the indebtedness in the event of the debtor's death or disa-

bility resulting from sickness or accident (Pet App. B. 11a).

Upon the issuance of the insurance, Georgia Life was required by state law to establish reserves on its books reflecting its liability to the policyholders. In the case of A&H coverage, the reserve was computed on the basis of "unearned premiums," *i.e.*, the amount of the premium attributable to periods of future coverage. Thus, in the first instance, the reserve was equal to the total premiums paid in advance (Pet. App. B 12a).

In order to reduce its A&H reserves, Georgia Life entered into a reinsurance agreement with its parent, First of Georgia Insurance Company (Georgia Insurance), on December 31, 1961 (Pltf. Ex. 12, A. 185–194). That agreement provided that 60 percent of the coverage on the A&H insurance issued by Georgia Life and 60 percent of the A&H premiums paid thereon would be ceded to Georgia Insurance.[5] The agreement further provided that Georgia Life was entitled to a maximum commission of 96 percent of the premiums earned on reinsured business, reduced dollar for dollar by the amount of claims paid (Pet. App. A 4a; Pet. App. B 12a–13a).

Thus, Georgia Life bore the entire ultimate insurance risk on the reinsured policies in an amount up to its 96 percent commission. Georgia Insurance's share of the premiums on the ceded coverage was limited to

[5] The agreement was later amended to provide that 70 percent of each A&H policy and the premiums paid would be ceded to Georgia Insurance (Pet. App. B 12a).

four percent of the premiums. Like the Treaty II arrangement in No. 75–1221, if the claims on the reinsurance in any particular period exceeded Georgia Life's 96 percent share of ceded premiums, Georgia Insurance was entitled to carry such excess forward against Georgia Life's commission for subsequent periods. However, during the period in question, the actual claims on the reinsured policies averaged only 22 percent of total premiums received (Pet. App. A 4a; Pet. App. B 13a–14a, A. 98).

Pursuant to the reinsurance agreement, Georgia Insurance accrued 60 percent of the premiums paid on the credit A&H insurance issued by Georgia Life, and reflected an unearned premiums reserve liability on its own books with respect to the A&H premiums. Georgia Life, in turn, took a 60 percent deduction from the unearned premiums reserves reflected on its own books for the A&H insurance. As in No. 75–1221, the Georgia Insurance officials did not challenge this treatment of reserves under the reinsurance agreement after their periodic examinations of Georgia Life's books (Pet. App. B 12a, 16a).

For federal tax purposes, petitioner took the position that its second-tier subsidiary Georgia Life was a "life insurance company" within the meaning of Section 801(a) of the Code. In its view, the reduction of part of Georgia Life's A&H reserves with respect to the A&H insurance ceded to Georgia Insurance enabled Georgia Life to meet the 50 percent test of Section 801(a) (A. 29–30; Pltf. Ex. 10, A. 183–184). Accordingly, petitioner excluded Georgia Life

from the group of its affiliated corporations that filed consolidated returns, and Georgia Life filed separate returns claiming the preferential tax treatment of a life insurance company (Pet. App. A 8a–9a).

B. On audit, the Commissioner of Internal Revenue determined that Georgia Life's "total reserves" should have included reserves for the A&H coverage purportedly ceded to Georgia Insurance and that it therefore failed to qualify as a "life insurance company" for any of the years in question. The Commissioner accordingly assessed deficiencies against petitioner, the parent of Georgia Life (Pet. App. A 9a). Petitioner paid the additional taxes and thereafter commenced this refund suit in the United States District Court for the District of Georgia (A. 3–23).

At the trial, the presidents of Georgia Insurance and Georgia Life acknowledged that tax considerations played a role in the decision to enter into the reinsurance arrangement (A. 66, 94). Because the profit of Georgia Life was reduced dollar for dollar by the loss experience up to 96 percent of the premiums, petitioner's expert witness conceded that the reinsurance arrangement did not transfer the risk of loss to Georgia Insurance (A. 122–123).

Professor Robert Zelten of the University of Pennsylvania Wharton School of Business, a qualified insurance expert by virtue of his teaching position in the Insurance Department of that school, testified that Georgia Life had improperly reduced its A&H reserves with respect to policies ceded to Georgia Insurance. He stated that "* * * the reinsurance agree-

ment entered into between Georgia * * * Life and Georgia Insurance * * * [was not really] a bona fide reinsurance agreement" (A. 155). Professor Zelten based his opinion "on the fact that the ceding commission * * * paid to Georgia * * * Life, would move dollar for dollar with losses incurred on the business reinsured, up to loss ratios of 96%, and therefore all of the loss experience directly impacted on Georgia * * * Life and not on Georgia Insurance" (A. 156). The contingency that the losses might exceed 96% did not affect Professor Zelten's opinion "because * * * the 96% potential breaking point in this case was really a remote possibility" (A. 156). Zelten was of the opinion that Georgia Life obtained no advantage from the arrangement other than a tax benefit (A. 178).

Professor Zelten's opinion was corroborated by the earlier testimony of Bobby Steed Clark, a Senior Examiner with the Georgia Department of Insurance (A. 130). In Clark's opinion, Georgia Life should not have deducted from its A&H reserves the unearned premiums attributable to the policies purportedly ceded to Georgia Insurance. Clark based his opinion on the fact that the reinsurance contract did "not shift any risk of loss, because the assuming company is always guaranteed 4%" (A. 136). As support for his conclusion, Clark cited the National Association of Insurance Commissioners Handbook (Govt. Ex. 2, A. 196–267). Clark explained that under that Handbook, the arrangement between Georgia Life and Georgia Insurance was a surplus aid contract and not

a reinsurance contract because it did "not result in the transfer to the reinsurer of the corresponding risk or liability—which is the major characteristic of a legitimate reinsurance transaction" (Govt. Ex. 2, A. 230). Finally, Clark testified that the 1967 Georgia insurance examination report, which stated without elaboration that the reinsurance contract appeared to be in good order, was "contrary to all reporting standards and practices" (A. 148) and had neither been accepted nor disapproved by the Georgia Department of Insurance (A. 146–149).

The district court held that Georgia Life was entitled to reduce its own reserves for federal tax purposes by an amount corresponding to the unearned premiums reserve established by Georgia Insurance on the ceded share of A&H coverage. The court rested its conclusion on its view that Georgia Life had a legitimate business purpose for entering into the agreement, *viz.*, that the agreement would reduce its ratio of net written premiums to surplus so as to enable it to expand its business (Pet. App. B 17a). It acknowledged, however, that the only risk Georgia Insurance actually assumed under the reinsurance agreement was that claims on the quota share of ceded A&H coverage would exceed 96 percent of the premiums (over four times the average claims experience on such policies), and that even this "loss" would be recaptured from Georgia Life unless it became insolvent (Pet. App. A 13a—14a). The district court nevertheless entered judgment in petitioner's favor for $102,655.09, plus interest (A. 268).

The court of appeals reversed, with one judge dissenting (Pet. App. A 1a–7a). It held that the economic substance of the arrangement was that Georgia Life continued to bear the insurance risk, while Georgia Insurance "for a 4% fee, provided in effect a line of credit in case periodic claims reached abnormally high levels" (Pet. App. A 4a). Since Georgia Insurance "did not bear any risks except the outside possibility of insolvency of [Georgia Life]," the court of appeals concluded that "there was no substance to the agreement as reinsurance" (Pet. App. A 4a–5a).

In so holding, the court of appeals followed the decision of the Seventh Circuit in *Economy Finance Corp.* v. *United States,* 501 F. 2d 466, certiorari denied, 420 U.S. 947, rehearing denied, 421 U.S. 922, motion for leave to file a second and untimely petition for rehearing pending No. 74–701. In the court of appeals' view, the Seventh Circuit correctly concluded that "Congress intended * * * to charge the company *actually* experienced the risk of claim losses with the corresponding 'reserves'—for the purpose of determining who was in the insurance business—as opposed to the loan business [footnote omitted; emphasis in original]" (Pet. App. A 6a).

III. No. 75–1285

A. Respondent Penn Security Life Insurance Company was incorporated under the laws of Missouri as a wholly-owned subsidiary of Aetna Finance Company, the assets of which are now owned by a wholly-owned

subsidiary of International Telephone & Telegraph Corporation known as ITT Aetna Corporation [6] (Pet. App. 30a). Aetna made consumer loans through subsidiaries operating more than 200 finance company offices in approximately 25 states (Pet. App. 3a, 31a). In connection with its loan transactions, it was common for Aetna's borrowers to apply for and receive credit insurance to provide for repayment of their loans in the event of death or disability. During the years in question (1963–1965), this insurance was issued by three companies: Old Republic Life Insurance Company, Pilot Life Insurance Company, and National Fidelity Life Insurance Company (Pet. App. 3a–4a, 32a).

Under the life insurance provisions of these policies, the insurer was required to pay Aetna any outstanding balance of the loan in the event of the insured debtor's death. The accident and health (A&H) provisions required the insurer to pay loan installments falling due while the insured was totally disabled and unable to work. The terms of the coverage were coextensive with the term of the related loan (Pet. App. 4a).

A&H insurance was sold to Aetna's borrowers only together with life insurance. However, the amounts

[6] Respondent instituted this suit as ITT Hamilton Life Insurance Company (A. 5). Counsel for respondent now advises that, as a result of a merger, respondent has changed its name to Massachusetts Indemnity & Life Insurance Company. However, we will continue to refer to respondent as Penn Security Life Insurance Company.

of the A&H insurance premiums were separately stated. All premiums were required to be paid in full by the insured debtor at the inception of the policy term (Pet. App. 33a, 39a–40a).

Respondent was organized by Aetna for the purpose of reinsuring the credit insurance coverage issued to Aetna's loan customers by Old Republic, Pilot, Nationl Fidelity and other companies. During 1963–1965, the taxable years at issue, respondent's business primarily consisted of reinsuring such risks pursuant to reinsurance agreements ("treaties") with Old Republic, Pilot and National Fidelity (Pet. App. 3a, 4a, 40a).

As in the case of Treaty I in No. 75–1221, respondent assumed the entire insurance risk under its reinsurance treaties by agreeing to reinsure 100 percent of the liability of each company with respect to life insurance and A&H insurance issued to Aetna and its borrowers. In exchange for assuming the insurance risk, respondent received the premiums paid thereon less a two percent commission to be retained by the issuing companies.[7] The treaties provided for the payments of reinsurance premiums with respect to life insurance coverage as they were received by the issuing companies (Exs. 1, 3, 5, A. 61–65, 73–78, 86–90). However, the A&H insurance premiums were paid to respondent on a monthly basis, and such payments represented that portion of the premiums al-

[7] Old Republic retained an 11 percent commission (Pet. App. 40a).

locable to the prior month's A&H coverage (Pet. App. 4a–5a, 40a; Exs. 2, 4, 6, A. 66–72, 79–85, 91–96).

Respondent was generally entitled to receive 98 percent of the premiums earned with respect to credit A&H insurance in force during the previous month. Thus, for example, if the issuing company received a $360 A&H premium on January 1, 1963, with respect to a 36-month policy, 1/36th of this premium ($10) would be allocable to coverage for the month of January and $9.80 would be paid over to respondent during the month of February (Pet. App. 5a, 40a–41a). Under the reinsurance treaties, respondent was liable to the issuing companies for the benefits covered by reinsurance to the same extent as the issuing companies were liable to the persons insured for such benefits. As a result, whenever a claim was made under a policy reinsured by respondent, respondent was required to consider it to be a claim for the full amount of reinsurance on the policy (Pet. App. 42a–43a).

For each of the years 1963, 1964, and 1965, respondent filed an annual statement with the Missouri Division of Insurance. These annual statements did not reflect any unearned premium reserves with respect to the A&H policies issued by Old Republic, Pilot, and National Fidelity and reinsured by respondent under its reinsurance treaties with those companies (Pet. App. 46a–47a). After audits by the Missouri Division of Insurance in 1965 and 1969, respondent was not required to establish unearned premium reserves with respect to the A&H insurance risks it assumed under the reinsurance agreements with Old

Republic, Pilot and National Fidelity (Pet. App. 47a–48a).

B. For each of its taxable years 1963, 1964, and 1965, respondent claimed the preferential tax treatment accorded life insurance companies on its federal income tax returns. Respondent took the position that it met the Section 801(a) definition of a "life insurance company" because its "life insurance reserves" exceeded 50 percent of its total reserves as reflected on its annual statements filed with the Missouri Division of Insurance (Pet. App. 37a).

Respondent thereafter claimed refunds of part of the taxes it paid for 1963–1965 on the ground that it was entitled to deduct certain losses in connection with the computation of its reserves. However, the Commissioner disallowed the refund claims. After respondent filed a petition in the Court of Claims seeking a refund of taxes paid on the basis of its subsequently claimed deductions, the Commisioner determined deficiencies of $965,774.95 for these years, based upon his conclusion that during those years respondent did not qualify for the preferential tax treatment accorded to life insurance companies. The Commissioner's determination was based upon his inclusion of the reserves for the A&H risks ceded to respondent in its "total reserves" under Section 801(c) because respondent had assumed the insurance risk on those policies. As a result, respondent's life insurance reserves did not comprise more than 50 percent of its total reserves as required by Section 801(a) (Pet. App. 8a, 57a–58a; A. 52).

216-901—76——3

Respondent paid the deficiencies and sought their refund in the suit it had already commenced in the Court of Claims (Pet. App. 8a–9a).[8] Over the dissent of the same judge who dissented in No. 75–1221 (see pp. 16–17, *supra*), the Court of Claims adopted its trial judge's recommended decision that the A&H insurance reserves could not be included in respondent's total reserves as "unearned premiums" under Section 801(e)(2) of the Code because the various issuing companies were in physical possession of the unearned portion of the premiums paid in advance on the A&H policies under the reinsurance treaties (Pet. App. 13a–21a).

The court concluded that respondent did not have to include the A&H insurance reserves as part of its total reserves because each monthly payment of A&H premiums made to respondent by the issuing companies represented premiums allocable to coverage for the prior month so they were not "unearned premiums" within the meaning of Section 801(e)(2) of the Code. In so holding, the court rejected the contrary conclusion on similar facts of the Seventh Circuit in *Econ-*

[8] The provisions of the Old Republic treaty differed from those of the Pilot and National Fidelity treaties as to the effect of termination upon insurance in force. In order to dispense with the need to consider the legal effect, if any, of such differences and because the A&H reserves with respect to the Old Republic treaty made no difference to the outcome of this case, the government agreed in the court below that they could be disregarded in computing respondent's total reserves (Pet. App. 38a).

omy Finance Corp. v. *United States*, *supra*, 501 F. 2d 466, certiorari denied, 420 U.S. 947, motion for leave to file a second and untimely petition for rehearing pending, No. 74–701 (Pet. App. 13a–19a).

The court also ruled that the A&H reserves were not includable in respondent's "total reserves" as "other insurance reserves required by law" under Section 801(e)(3) of the Code because the Missouri Insurance Department did not take any action against respondent to require it to establish reserves for the A&H coverage it reinsured.[9] Accordingly, the court held that respondent qualified as a "life insurance company" under Section 801(a) of the Code (Pet. App. 21a–22a).

In concluding that the A&H reserves were properly attributable to respondent, the dissenting judge stated that "[respondent] maintains the reserves for purposes of the 801(a) test, though for no other purposes, because it has arranged, itself or through its affiliates, and using the economic leverage they jointly possess, to have these reserves available to satisfy the right of the [A&H] policyholders to have their risks covered by legally acceptable reserves" (Pet. App. 29a–30a).

[9] The court therefore found it unnecessary to reach the alternative contention raised by respondent (which the Seventh Circuit rejected in *Economy Finance Corp.* v. *United States*, *supra*, 501 F.2d at 482–483) that only the "morbidity" portion of A&H premiums should be taken into account in attributing A&H reserves for purposes of determining "total reserves" under Section 801(e).

SUMMARY OF ARGUMENT

1. Under the Internal Revenue Code of 1954, life insurance companies enjoy the preferential tax treatment of a narrowed tax base. Other stock insurance companies, such as those engaged in the sale of cancellable accident and health insurance and other forms of casualty insurance, are generally taxable on their total annual net income. These cases present the question whether the taxpayer insurance companies are eligible for life insurance company status.

The precise issue focuses upon the application of the reserve-ratio test of Section 801(a) of the Code. Like the taxpayers, many life insurance companies do not deal exclusively in either life or non-life insurance but in a combination of the two types of policies. Section 801(a) provides an objective mathematical test designed to limit the preferential life insurance company tax treatment to those companies whose predominant business is the assumption of life insurance risks.

The reserve-ratio test requires the calculation of the following fraction—

$$\frac{\text{Life Insurance Reserves}}{\text{Total Reserves}}$$

and restricts life insurance company status to those companies whose reserve ratios exceed 50 percent. The controversy in these cases is whether certain cancelable accident and health insurance reserves are includable in the taxpayers' "total reserves," *i.e.*, the denominator of the fraction. If they are so includable, the taxpayer companies' reserve ratios will be less than 50 percent, so as to disqualify them from preferential life insurance company tax treatment.

2. In these three cases, the taxpayers entered into reinsurance arrangements that attempted to shift the accident and health insurance reserves to other companies on a temporary basis in order to become eligible for life insurance company status. But under each of the two types of arrangements at issue, the taxpayers continued to bear the ultimate insurance risk under the accident and health coverage because the policyholder claims were paid from the very premium dollars that were temporarily held by the other companies on behalf of the taxpayers. As the Seventh Circuit concluded in *Economy Finance Corp.* v. *United States,* 501 F. 2d 466, 478, certiorari denied, 420 U.S. 947, with respect to a virtually identical arrangement, the role of the other companies was simply that of a paymaster for which they received a small commission.

Thus, the form of the arrangements cannot mask the economic reality that the taxpayers at all times bore the ultimate liability to the accident and health policyholders. Since the essence of insurance is risk-shifting (*Helvering* v. *LeGierse,* 312 U.S. 531, 539) and the purpose of an insurance reserve is to meet claims under the policies, the accident and health reserves are includable in the taxpayers' "total reserves" under Section 801(c). Simply put, the reserves can only be attributed to the company that assumes the corresponding insurance risk.

3. The statutory language of Section 801(c) supports the inclusion of the accident and health insurance reserves in the taxpayers' "total reserves." Section 801(c)(2) requires the inclusion of "unearned premiums" in a company's "total reserves." The terms and legislative history of the reserve ratio test of Section 801 demonstrate that it is designed to measure the predominant element of a company's insurance business by the yardstick of reserves. Thus, every item to be included in the computation of "total reserves" necessarily is a type of insurance reserve and not a type of asset. The statutory term "unearned premiums" therefore refers to the unearned premium reserves of the accident and health coverage by which potential liability under non-life insurance is traditionally measured. While that measure is mathematically equal to the "unearned" portion of the gross premiums paid by the policyholder, the reserve is not conceptually equivalent to the premium dollars themselves.

The fundamental error of the Court of Claims' ruling that the accident and health reserves were not attributable to the taxpayers was to confuse the concept of "unearned premium reserve" with the unearned premiums themselves. The unearned premium *reserve* represents the potential liability to the policyholder and can therefore only be attributed to the company that bears the liability, *viz.*, the reinsurer of the risk. However, the unearned premiums are the amount of premium dollars collected that are allocable to periods of future coverage.

A company that simply holds unearned premiums on behalf of another company until they are earned cannot include the equivalent amount in a reserve for "unearned premiums" under Section 801(c)(2) unless it has the ultimate liability to meet the policyholder claims. Since the taxpayers had the ultimate liability for the accident and health policy claims, the "unearned premiums" are attributable to them in computing their "total reserves" under Section 801(c).

4. The inclusion of the accident and health reserves in the taxpayers' "total reserves" is also confirmed by the applicable state law as both "unearned premiums" under Section 801(c)(2) and as "other insurance reserves required by [state] law" under Section 801(c)(3). In rejecting this basis for inclusion of the accident and health reserves, the Court of Claims rested its decision in part upon the fact that neither the Georgia, Arizona nor Missouri state insurance authorities took any action against the taxpayers' failure to establish such reserves for state reporting purposes. But any reliance upon state examiners' inaction is unjustified in the face of the uncontradicted testimony of the state insurance officials in No. 75–1221 (*Consumer Life*) that their failure to act was a consequence of their unfamiliarity with these arrangements.

Finally, the language of the pertinent state insurance statutes demonstrates that the taxpayer companies were required to establish unearned premium reserves for the accident and health coverage under both the reinsurance arrangements at issue here. Thus, the applicable state law is in accord with the general

rule that we urge in these cases, *viz.*, that the insurance reserves follow the insurance risk.

ARGUMENT

AN INSURANCE COMPANY DOES NOT QUALIFY FOR TAXATION AS A LIFE INSURANCE COMPANY UNLESS ITS LIFE INSURANCE RESERVES EXCEED 50 PERCENT OF THE TOTAL RESERVES ATTRIBUTABLE TO POLICIES UPON WHICH IT BEARS THE ULTIMATE INSURANCE RISK

A. INTRODUCTION

These cases involve the application of the familiar axiom that economic substance rather than form is controlling for purposes of federal taxation. The rule rests upon the well-established principle that taxation is a practical matter that is not so much concerned with the labels put upon a transaction by the parties as it is with the actual import of the arrangement. If the labels are at odds with the economic reality, the courts have not hesitated to disregard them in determining the tax consequences of a contractual relationship.

Since the enactment of the modern income tax system in 1913, this Court has applied the substance-over-form doctrine in a number of landmark decisions that have been a major influence in shaping the development of our federal tax jurisprudence. Thus, for example, the Court has held that a taxpayer who is entitled to receive income and makes a gift of it by an anticipatory assignment, realizes taxable income just as if he had collected the income and paid

it over to his donee. See, *e.g.*, *Lucas* v. *Earl,* 281 U.S. 111; *Helvering* v. *Horst,* 311 U.S. 112; *United States* v. *Basye,* 410 U.S. 441.

Lucas v. *Earl, supra,* is the seminal precedent. In rejecting the attempt of a taxpayer to deflect one-half of his future earned income to his wife by contract and thereby reduce his overall tax liability under the graduated rates, the Court stated (281 U.S. at 114–115):

> [T]his case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act. There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

The Court has likewise set aside temporary assignments of income when the donor retains the ownership of the income-producing property (*Helvering* v. *Clifford,* 309 U.S. 331; *Corliss* v. *Bowers,* 281 U.S. 376); denied interest deductions where there was no economic borrowing (*Knetsch* v. *United States,* 364 U.S. 361); and imposed estate taxation in accordance with "the nature and operative effect of [a reciprocal]

trust transfer" (*United States* v. *Estate of Grace,* 395 U.S. 316, 323). Indeed, in *Gregory* v. *Helvering,* 293 U.S. 465, the Court refused to give effect to a corporate transaction that met all of the requirements of a tax statute because "[t]he whole undertaking * * * was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else" (293 U.S. at 470). As the Court there concluded (*ibid.*), "[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision * * * of all serious purpose."

Stripped of their technical insurance terminology, these cases involve the application of a specific and detailed Code provision that embodies the principle of substance over form. Suppose, for example, A has accounts receivable and engages B to collect them for him on a commission basis, pay certain of A's obligations out of the receipts, and remit the balance to A at stated intervals. It requires no citation of authority that, as a matter of economic substance, the receipts and disbursements from the fund are attributable to A for tax purposes, notwithstanding B's physical possession and nominal control over the fund. Thus, if B were to establish a reserve for bad debts on its books to take into account estimated worthless receivables, B's additions to that reserve would be reflected as deductions on A's tax return because the estimated losses would be A's losses and not those of B. The role of B is simply that of a commission agent or bookkeeper.

The taxpayers in these cases stand in the place of A

in the foregoing example. They contend, and the Court of Claims has held in two of the three cases under review, that insurance reserves that are analogous to the bad debt reserves in the example, are attributable for tax purposes to companies standing in the place of B. Simply put, the question presented is whether an insurance company can temporarily shift the premiums on its non-life business to another company so as to preserve its qualification as a company whose predominant business is life insurance, and yet continue to profit from and bear the risk of loss on the non-life business by ultimately receiving the non-life premiums less claims paid.

It is our position that the contractual arrangements between the taxpayers and the other companies in these cases did not shift their non-life reserves to those other companies. The terms of the statutory definition of a "life insurance company," to which we now turn, confirm that the predominant element of the taxpayers' business was non-life insurance throughout the taxable years at issue so as to disqualify them from preferential life insurance company tax treatment.

B. THE LANGUAGE OF SECTION 801(C) SUPPORTS INCLUSION OF THE ACCIDENT AND HEALTH RESERVES IN THE TAXPAYERS' "TOTAL RESERVES"

Section 801(a) defines a "life insurance company" as an insurance company whose "life insurance reserves" comprise more than 50 percent of its "total

reserves." Section 801(c) in turn defines the term "total reserves" to mean—

> (1) life insurance reserves,
>
> (2) *unearned premiums,* and unpaid losses (whether or not ascertained), not included in life insurance reserves, and
>
> (3) all other insurance reserves required by law [emphasis supplied].

In these cases, the taxpayers entered into two types of reinsurance arrangements that attempted to shift their non-life (accident and health) reserves to other companies. While we discuss the details of each of the two transactions in Part D, *infra,* pp. 51–66, the essential element of both arrangements was to have another insurance company temporarily hold non-life premiums on which the taxpayers bore the insurance risk and pay them over to the taxpayers (less claims paid) after they were "earned," *viz.,* after the expiration of the period of coverage to which they were allocable. Thus, if the single premium was $120 per year payable on January 1, the other company would pay over to the taxpayers the $10 attributable to the January coverage on or after February 1.

The taxpayers contend, and the Court of Claims held in *Consumer Life* and *Penn Security,* that the payment of the non-life premiums to them on a delayed basis shifted the reserves on the accident and health coverage to the other companies because they received the non-life premiums only after they were "earned." Their argument relies on the statutory term "unearned premiums" in Section 801(c)(2). Since the other companies held the premiums during the period

they were "unearned," the taxpayers urge that they had no "unearned premiums" attributable to non-life coverage to be included in their "total reserves."

The structure and terminology of Section 801(c), viewed in the light of accepted insurance concepts, demonstrate the fallacy of this reasoning, which confuses a reserve liability account with the premium dollars themselves. Section 801(c) defines the types of reserves that are to be included in determining a life insurance company's "total reserves," in order to ascertain whether the life insurance reserves exceed 50 percent of total reserves. The definition, like the standard in Section 801(a), deals with a single subject: reserves. Its purpose is to distinguish the reserves that are to be included as a part of total reserves from those that are to be excluded.

For example, a life insurance company's total reserves might include many non-insurance reserves, such as that for depreciation of its building and equipment. The definition in Section 801(c) makes it explicit that the "total reserves" for purposes of Section 801(a) are limited to those involved in the insurance aspects of the business and to such of the latter as the definition covers.

In other words, the three subcategories in Section 801(c)—life insurance reserves, unearned premiums and unpaid losses, and all other insurance reserves required by law—specify three general types of insurance reserves, not two types of reserves and one type of asset. The term "unearned premiums," as used in Section 801(c)(2), is one of those types of reserves.

216-901—76——4

"Unearned premiums" connotes the unpaid premium *reserve* which traditionally represents the measure of the liability of an insurance company to meet claims for short-term casualty coverage. See Hammond, *Insurance Accounting Fire and Casualty,* p. 177 (2d ed. 1965). That term does not, as the Court of Claims erroneously believed, refer to the actual premium dollars on hand during the period of coverage. As the Court of Claims previously observed with respect to casualty insurance, "Every insurance company sets up a *reserve for unearned premiums,* but this is not done in anticipation of the possibility that some part of the premiums will have to be returned, but *to take care of anticipated losses on the policies.*" *Colonial Surety Co.* v. *United States,* 178 F. Supp. 600, 602 (Ct. Cl.) (emphasis supplied).

Similarly, the term "unpaid losses" in Section 801(c)(2) refers to another type of insurance reserve which represents the company's liability to recognize losses that have occurred. See Hammond, *Insurance Accounting Fire and Casualty,* p. 148. This is further confirmed by the modifying phrase "not included in life insurance reserves" immediately after "unpaid losses." The use of this modifying phrase demonstrates that the term "unpaid losses" in Secion 801 (c)(2) connotes a reserve for unpaid losses with respect to non-life insurance.

Finally, Section 810 of the Code offers additional statutory evidence that the term "unearned premiums" refers to the unearned premium reserve. In prescribing rules for various reserves, Section 810

(c)(2) provides that "unearned premiums and unpaid losses included in total reserves under section 801 (c)(2)" are to be taken into account in making upward and downward adjustments to reserves.

In these circumstances, it is immaterial that Congress used the word "reserves" in formulating the definitions in subsections (1) and (3) of section 801 (c), but did not speak of "unearned premium reserves" and "unpaid loss reserves" in subsection (2). There is no reason to suppose that when Congress defined what types of reserves it intended to include in "total reserves," it intended subsection (2) to mean anything other than its obvious context, *i.e.,* reserves for unearned premiums and unpaid losses. The most likely explanation for the failure of Congress to use the term "reserves" in defining the second category of "total reserves" was that, as indicated above, in the insurance business "unearned premiums" and "unpaid losses" ordinarily are viewed connoting the reserves for those items.

The phrase "unearned premiums" therefore refers to the unearned premium *reserve* that reflects an insurance company's liability to meet casualty insurance claims. If, as we shall demonstrate, the taxpayer companies continued to bear the risk of meeting claims under the accident and health coverge, the accident and health unearned premium reserves attributable to such coverage must be included in their "total reserves" under the statute, despite the temporary physical possession of the unearned premium dollars by the other companies.

C. THE 50 PERCENT RESERVE RATIO TEST OF SECTION 801 (a) RESTS UPON THE PRINCIPLE THAT INSURANCE RESERVES ARE ATTRIBUTABLE TO THE COMPANY THAT ASSUMES THE CORRESPONDING RISKS

1. Under the Internal Revenue Code of 1954, life insurance companies enjoy tax treatment that is markedly more favorable than that of other types of insurance companies.[10] The structure and operation of the present statutory system for the taxation of life insurance companies are summarized in *United States* v. *Atlas Life Ins. Co.*, 381 U.S. 233, 235–238, and *Jefferson Standard Life Ins. Co.* v. *United States*, 408 F.2d 842, 844–846 (C.A. 4), certiorari denied, 396 U.S. 828. For present purposes, it is sufficient to state that Sections 801–820 of the Code provide a special three-phase procedure for the taxation of life insurance companies that considerably narrows their tax

[10] Special tax treatment for life insurance companies originated in Sections 242–247 of the Revenue Act of 1921, 42 Stat. 261–264. Prior to 1921, all types of insurance companies were taxed in the same manner as other corporations on all of their net income, except that they were allowed a special deduction for the "net addition required by law to be made within the taxable year to reserve funds * * *." See Section 234(a)(10) of the Revenue Act of 1918, c. 18, 40 Stat. 1057. Between 1921 and the enactment of the present Code provisions dealing with the taxation of life insurance companies, such companies were taxable on only part of their investment income and none of their underwriting income. See generally *A Preliminary Statement of the Facts and Issues with Respect to the Federal Taxation of Life Insurance Companies*, Hearings on Federal Taxation of Life Insurance Companies before a Subcommittee of the House Committee on Ways and Means, 83d Cong., 2d Sess., pp. 3, 18–22 (1955); and H.R. Rep. No. 34, 86th Cong., 1st Sess., pp. 1–5 (1959).

base. Pursuant to Section 802(b), the total tax base of a life insurance company to which the ordinary corporate rates are applied is the sum of the tax bases derived from computations under each of the three phases.

The Phase I tax base (Section 802(b)(1)) is the smaller of "taxable investment income" or "gain from operations." The Phase II tax base is equal to 50 percent of the excess, if any, of the gain from operations over taxable investment income (Section 802(b)(2)). Finally, the deferred portion of underwriting income that is not taxed under Phase II becomes the Phase III tax base when such income is made available to shareholders (Section 815).

On the other hand, stock insurance companies other than life insurance companies, such as those engaged in the sale of cancellable accident and health insurance and other forms of casualty insurance, are generally taxable on their total annual net income as any other corporation. See Sections 831 and 832 of the Code.

"Historically and commonly insurance involves risk-shifting and risk-distributing." *Helvering* v. *Le-Gierse*, 312 U.S. 531, 539. The difference between the tax treatment of a life insurance company and other types of insurance companies reflects the distinction between life and non-life risks.

Life insurance contracts generally involve the assumption of long-term risks that increase over the period of coverage and that will ultimately require the payment of a claim. In order to provide for the certainty of the death of its policyholders, the company

must accumulate a fund from the investment of premiums. The company's liability to its policyholders for this fund, computed on the basis of a recognized table and an assumed rate of interest, constitutes the "reserve" that the company must have on hand against its outstanding policies. See *Williams* v. *Union Central Life Ins. Co.*, 291 U.S. 170, 177. Thus, the three-phase tax computation established by Congress in 1959 recognizes that such companies are required to maintain policyholder reserves to meet future claims and that the annual increments to the reserves should be free of tax.

Moreover, the long-term risk inherent in life insurance makes it difficult to measure the "profit" of a life insurance company within the relatively short time frame of a single taxable year. In any given year, benefits paid could either be greater or less than the amounts that had been estimated under the actuarial tables As a result, Congress has permitted life insurance companies to defer the tax upon 50 percent of their underwriting income until it is distributed to its shareholders See H.R. Rep. No. 34, *supra,* pp. 2–4; S. Rep. No. 291, 86th Cong., 1st Sess., pp. 3–7 (1959).

The foregoing considerations are not applicable to cancellable accident and health insurance because that type of coverage does not involve the assumption of long-term risks for which the payment of benefits is certain to occur many years in the future. Unlike life insurance, the reserves for short-term casualty insurance do not involve the accumulation of reserves at an assumed rate of interest but are simply measured by the premiums themselves. Thus, in the case of casualty

insurance such as the accident and health coverage involved in these cases, the reserve is measured solely by the unearned premiums, *i.e.,* that portion of the premiums attributable to periods of future coverage without regard to income assumed to be generated by the premiums. If the premium is $120 per year, paid as of December 1, the unearned premiums reserve as of December 31 is $110. Finally, because of the short-term nature of its cancellable risks, a casualty insurance company can measure its taxable income with reasonable accuracy in any given year by including in income its earned premiums collected and deducting its insurance reserves, the claims paid, and its other expenses of operation.

As a result, Congress has consistently provided for taxation of such non-life insurance companies in much the same manner as any other corporation. See Sections 831 and 832 of the Code.

2. Once it is recognized that the preferential tax treatment accorded to life insurance companies is premised upon the special characteristics of life insurance risks, it is apparent that a company's eligibility for life insurance company status necessarily turns on whether it in fact assumes life insurance risks. Suppose, for example, a company issues only life insurance policies but thereafter transfers all of the risks under such policies to another company under a reinsurance agreement, retaining only a commission for itself. Under those circumstances, the issuing company is simply a commission agent and not a life insurance company because it has parted completely with the

risk of insurance. Conversely, if the issuing company retains the life insurance risks but engages another company for a fixed fee to administer the collection of premiums and the payment of claims and to pay over the balance to the issuing company, the issuing company is a life insurance company because it enjoys the benefits and bears the burdens of the life insurance business.

Like the companies in these cases, many insurance companies do not deal exclusively in either life or non-life insurance but in a combination of the two types of policies. It was therefore necessary to devise a method for determining how to tax such "mixed" enterprises. Thus, as early as Section 242 of the Revenue Act of 1921, 42 Stat. 261, Congress established an objective mathematical test designed to limit the preferential life insurance company tax treatment to those companies whose life insurance reserves "comprise more than 50 percentum of its total reserve funds." As Dr. T. S. Adams, Tax Advisor to the Treasury Department, explained to the Senate Finance Committee in 1921 (Hearings on H.R. 8245, Internal Revenue, before the Senate Committee on Finance, 67th Cong., 1st Sess., p. 85 (1921)):

> Some companies mix with their life business accident and health insurance. It is not practicable for all companies to disassociate those businesses so that we have assumed that *if this accident and health business was more than 50 percent of their business, as measured by their reserves,* it could not be treated as a life insur-

> ance company. On the other hand, if their accident and health insurance were incidental and represented less than 50 percent of their business we treated them as a life insurance company [emphasis supplied].

Since 1921 an insurance company has been taxed as a life insurance company only if its predominent business is the assumption of life insurance risks. See, *e.g., National Protective Ins. Co.* v. *Commissioner,* 128 F. 2d 948, 950 (C.A. 8), certiorari denied, 317 U.S. 655; *New World Life Insurance Co.* v. *United States,* 26 F. Supp. 444, 461 (Ct. Cl.), affirmed on another issue, 311 U.S. 620; *Commissioner* v. *Monarch Life Ins. Co.,* 114 F. 2d 314, 324–325 (C.A. 1).

In tying life insurance company status to life insurance reserves, the foregoing excerpt from the legislative history demonstrates that Congress employed the reserves concept as the proper measure of the amount and character of a company's insurance business for purposes of determining its tax status. As the Court of Claims has previously stated, "it was the character of an insurance company's business *as measured by its policy reserves* that served as the touchstone for the definition of 'life insurance company.'" *Alinco Life Inc. Co.* v. *United States,* 373 F.2d 336, 347 (emphasis in original). Since the function of insurance reserves is to provide a fund to meet future policyholder claims, the reserves will be an accurate gauge of the business only of the company that assumes the economic risk of meeting the claims under the policies attributable to the reserves, ~~viz.~~ viz., the com-

216-901—76——5

pany and that makes the profits or suffers the losses from assuming that risk.

In short, for purposes of measuring the predominant element of the business of an insurance company engaged in issuing different types of risks by the yardstick of reserves, the reserves must be attributed to the company that actually assumes the insurance risk on the corresponding policies.

Section 801(a) of the 1954 Code, the terms of which we have previously analyzed (*supra,* pp. 37–41), continues essentially the same 50 percent reserve ratio test first set forth in Section 242 of the 1921 Act. Under Section 801(a), a "life insurance company" is defined as an insurance company whose life insurance reserves plus its unearned premiums and unpaid losses on noncancellable life, health or accident policies [11] comprise more than 50 percent of its total reserves. Section 801(c) in turn defines the term "total reserves" as consisting of: (1) life insurance reserves; (2) unearned premiums and unpaid losses not included in life insurance reserves; and (3) all other insurance reserves required by law.

[11] The taxpayers in these cases have not contended that the accident and health policies were "noncancellable life, health, or accident policies" which would be eligible for inclusion in both the numerator and the denominator under the 50 percent test of Section 801(a)(2). Under the accident and health coverage in question, the insured did not have a guaranteed option to renew on the expiration of the initial term. Thus, it was not "noncancellable" within the meaning of the statute. See *Economy Finance Corp.* v. *United States*, *supra*, 501 F.2d at 480–482; *Superior Life Insurance Co.* v. *United States*, 462 F.2d 945, 951 (C.A. 4).

During the years in question, the taxpayers in these cases were engaged in the business of insuring both credit life and credit accident and health (A&H) risks. In each instance, the predominant element of their business, as measured by the respective reserves appropriate to the two types of polices, was the assumption of non-life A&H risks. Thus, had the taxpayers directly established unearned premium reserves appropriate to the A&H risks they assumed and included such amounts in their "total reserves"—the denominator of the Section 801(c) reserve ratio—it is undisputed that they would have failed to meet the 50 percent test of Section 801(a) and would therefore have been ineligible for the preferential life insurance company tax treatment. However, in an attempt to keep their A&H reserves below 50 percent of their total reserves, each taxpayer entered into contracts that purported to shift the A&H reserves to other companies by arranging for the other companies to hold the advance A&H premiums until such time as they were "earned," *i.e.,* until the expiration of the period of coverage attributable to such reserves.[12]

[12] Apart from the tax-avoidance motivation for these transactions, petitioner First Railroad introduced testimony that its Treaty II-type arrangement was intended to spread the risk which would enable it to expand the volume of A&H business (No. 75–1260—A. 66–67). But as Professor Zelten explained, the agreement should not have been given the effect of divesting Georgia Life of the full reserve for unearned premiums on the A&H policies, and should not have enabled it to expand its business because (1) it did not actually reduce the risks to which the company was subject, and (2) it adversely affected the company's true financial status by permanently shifting four percent of premiums paid to Georgia Insurance (A. 154–156, 159–163).

The various contractual arrangements between the taxpayers and the other companies did not shift the A&H reserves to those other companies. The fact that the A&H premium dollars were not physically paid over by the other companies to the taxpayers until they were "earned" does not justify the Court of Claims' conclusion that the reserves based upon "unearned premiums" were attributable to those other companies. Indeed, "physical possession" of the premiums is something of an anomaly in our modern economy where money is largely represented by bank deposits and similar intangible claims. The taxpayers in these cases had the same claims to the unearned premiums that they would have had to time deposits in a bank. They were therefore equally an asset to the taxpayers, calling for the establishment of a corresponding reserve.

The function of an insurance reserve is to represent the insurer's estimated liability to the policyholders. Since the obligation to meet A&H policy claims was borne by the taxpayers throughout the periods of coverage by their assumption of the insurance risk, the unearned premium reserves reflecting that obligation were properly attributable to the taxpayers and not to the other companies. Thus, to conclude that the A&H reserves should be attributed to the companies that temporarily held the premiums in exchange for a commission would elevate the "attenuated subtleties" of bookkeeping formalities over the substance of the

insurance business represented by the assumption of the insurance risk.

D. THE REINSURANCE ARRANGEMENTS IN THESE CASES DID NOT SHIFT THE ACCIDENT AND HEALTH RESERVES FROM THE "TOTAL RESERVES" OF THE TAXPAYER COMPANIES TO THE OTHER COMPANIES THAT WERE PARTIES TO THE ARRANGEMENTS BECAUSE THE TAXPAYERS BORE THE ULTIMATE INSURANCE RISK ON THE ACCIDENT AND HEALTH POLICIES

As the foregoing portion of this brief demonstrates, the reserve ratio test of Section 801(a) is designed to measure the relative quantities of the various types of a company's insurance business and to accord life insurance company status only to those companies whose life insurance business is the dominant element. Since the essence of insurance is the assumption of risks, the test can only accurately measure the predominant element of a company's business if the reserves are attributed to the company that assumes the insurance risks reflected by the reserve.

We do not suggest that once a company assumes an insurance risk and establishes a reserve to meet claims, it can never transfer the risk to another company. Such a transfer is commonly achieved by means of a contract or treaty of reinsurance. Under such arrangements, the original insurer (called the ceding company) agrees to transfer and the reinsurer agrees to accept all or a fixed share of a risk for a certain consideration.

But just as the fundamental attribute of insurance is the assumption of a risk, the *sine qua non* of reinsurance is the transfer of a risk. As a widely-used authority states, "[t]he essential element of every true reinsurance contract is the undertaking by the reinsurer to indemnify the ceding insurer, not only in form but in fact, against loss or liability by reason of the original insurance." National Association of Insurance Commissioners, *Examiners Handbook,* Part B, p. B6 (1970 ed.) (Govt. Ex. 2, No. 75–1260—A. 211). See also *id.* at pp. B23–B24 (No. 75–1260—A. 249–253).

The question therefore is whether the various arrangements in these cases were in fact reinsurance agreements, *i.e.,* did they transfer a risk from the ceding company to the reinsurer. Our analysis focuses upon the two reinsurance treaties (I and II) involved in No. 75–1221 (*Consumer Life*) because they are representative of the arrangements in all three cases.

1. *Treaty I.* Pursuant to Treaty I, respondent Consumer Life reinsured the risk on all credit life and A&H insurance directly issued by American Bankers to individuals obtaining loans from respondent's parent. The treaty provided that respondent would reimburse American Bankers "for all losses actually paid on [both] Life policies * * * and Health and Accident policies * * *" approximately 40 days after American Bankers' submission of its monthly statement (Pet. App. B 113a–114a). Respondent therefore freely conceded in the court below (A. 130–133), and the court so found (Pet. App. B 70a), that it assumed the entire

insurance risk on both the life and A&H insurance.[13] In exchange for the assumption of these risks, respondent received 87½ percent of the premiums collected by American Bankers (Pet. App. B 70a–71a, 113a–114a).

As the direct insurer, American Bankers collected all of the single payment premiums in advance and initially paid all claims under the policies. Each month American Bankers paid over to respondent its full share of all life insurance premiums received by it during the preceding month. However, with respect to the A&H premiums, American Bankers remitted to respondent each month only that portion of the premiums that was ratably allocable to the coverage for the prior month.

For example, if American Bankers collected $120 in A&H premiums for a one-year policy on January 1, it would not pay over to respondent the $10 allocable to the January coverage (less its 12½ percent commission) until February 1. The payment attributable to the February installment would be paid on March 1, and so on. Thus, while respondent received its share

[13] In its brief in opposition (p. 2), Consumer Life denies it conceded that it assumed the entire risk on the life and A&H policies under Treaty I. But the record shows that respondent's counsel explicitly acknowledged that "ultimately way on out many, many months or years, 100 percent of the risk would be borne by Consumers. There's no question about that" (A. 131). Shortly thereafter, he likewise stated that "ultimately they [Consumer Life] still have that 100 percent exposure on that loss, but the only question is when they are liable for it" (A. 132). There is accordingly ample support for the Court of Claims' finding (Pet. App. B 70a).

of life insurance premiums almost immediately upon issuance of the policies, it received its share of the A&H premiums only after the periods of coverage attributable to the premiums had expired (Pet. App. B 70a–71a, 110a–117a).

a. Under the settled definition of reinsurance, Treaty I, as well as its essentially parallel counterpart in No. 75–1285 (*Penn Security*),[14] is a true reinsurance agreement because American Bankers transferred the insurance risk to respondent Consumer Life. Apart from respondent's concession that this was the case, the agreement explicitly stated that respondent would reimburse American Bankers for all losses paid on the policies. Thus, American Bankers' role was that of a paymaster; it collected the premiums and disbursed the claims. Consumer Life indemnified American Bankers for the claims and thereby bore the economic burden of meeting them.

All of this is clear with respect to the life insurance premiums. Indeed, respondent Consumer Life implicitly admits that it assumed the risk of the life insurance written by American Bankers, because it claims the reserves attributable to those policies as its life insurance reserves for purposes of the Section 801(a) reserve ratio test. However, respondent contends and the Court of Claims held that the A&H

[14] The only difference between Treaty I and the various reinsurance treaties involved in No. 75–1285 was that, in the latter case, respondent Penn Security was generally entitled as reinsurer to receive 98 percent of the premiums earned with respect to the A&H insurance in force for the preceding month (Pet. App. 42a–43a).

reserves were not includable in its "total reserves" because it did not physically receive its share of the A&H premiums until after the expiration of the period of coverage to which the premiums were allocable. In the Court of Claims' view, the A&H reserves were part of American Bankers' "total reserves" under Section 801(c)(2) because American Bankers held the A&H premiums until they were "earned."

The difference in timing between American Bankers' transmission of the life and of the A&H premiums to Consumer Life does not warrant a different federal tax result where the ultimate destination of those premiums was provided for at the outset. As we have noted earlier, "physical receipt" is something of an anomaly in the context of funds to which Consumer Life had a contractual right. "A given result at the end of a straight path is not made a different result because reached by following a devious path." *Minnesota Tea Co.* v. *Helvering,* 302 U.S. 609, 613. From Consumer Life's standpoint, it was obligated to reimburse American Bankers for claims paid with respect to *both* the life and A&H coverage. Thus, the fact that Consumer Life received the A&H premiums on a one-month delayed schedule cannot serve to shift the A&H reserves to American Bankers when Consumer Life in fact had the right to receive the A&H premiums reflected by those reserves and employed American Bankers to use them to indemnify itself for its initial payments of policy claims.

When American Bankers paid A&H claims, it was doing so on behalf of Consumer Life and not on its own account. Since the purpose of an insurance reserve is to meet estimated policy claims, the A&H reserves are properly attributable to Consumer Life because it and not American Bankers met the claims under the A&H insurance. The paymaster role of American Bankers is therefore an insufficient basis for attribution to it of the A&H reserves because it put none of its own assets at the risk of the A&H insurance business.[15] As the Seventh Circuit observed in *Economy Finance Corp.* v. *United States, supra,* 501 F. 2d at 478, in characterizing the role of a company analogous to American Bankers in an arrangement virtually identical to Treaty I: "[It] performed a banking and clearing house function and not an insurance function."

Because American Bankers paid the A&H claims on behalf of Consumer Life and not on its own account,

[15] A variation on the Treaty I-type arrangement was involved in *Superior Life Insurance Co.* v. *United States*, 462 F.2d 945 (C.A. 4). There, the taxpayer issued credit life and credit A&H policies with respect to loans made by its parent, which acted as the sales agent for such policies. The parent immediately paid over the life premiums to the taxpayer, but, as in the case of Treaty I, remitted the A&H premiums on a monthly basis as "earned." While the case did not involve a reinsurance agreement, the effect of the arrangement, which the court held insufficient to shift the A&H reserves to the parent for purposes of the reserve ratio test, is essentially the same as that of the Treaty I-type arrangements in these cases. While the court rested its decision in part upon the agency relationship of the parties (*id.* at 950), the instant cases are essentially identical because of the taxpayers' contractual right to the A&H premiums less claims and commissions.

a useful non-insurance analogy to these cases is *Commissioner* v. *Hansen*, 360 U.S. 446. There, accrual basis automobile dealers had sold customer installment obligations to finance companies. Because the finance companies were unwilling to assume the risk that the customers would not pay on the notes, they required the dealers to reimburse them for losses arising from non-payment. When the dealers assigned the installment obligations to the finance companies, the finance companies paid the agreed price to the dealers, which included a percentage the finance companies retained in a "dealer's reserve" to cover the dealer's contingent liabilities. After an appropriate period, the amounts retained, less any amount applied to cover the dealer's actual liabilities under the agreement, were paid over to the dealers.

On these facts, the Court held that the sums in the dealers' reserve were "vested in and belonged to" (*id.* at 463) the dealers and should be accrued in their income at the time of their assignment of the installment obligations. As the Court analyzed the economic realities of the arrangement, the funds in the dealers' reserves were currently taxable to the dealers because they would either ultimately be given to the dealers or applied for their benefit against their contingent obligations to the finance companies. Here, too, the "unearned premiums" on the A&H coverage would either be paid over to the taxpayers or applied against their contingent obligations to the policyholders. Under these circumstances, the *Hansen* principle requires that the taxpayers take the unearned premiums into

account for tax purposes and include them in their "total reserves" under Section 801(c).

b. While the Court of Claims acknowledged in *Penn Security* that its holding would produce "some anomalies" "which can be questioned on economic or actuarial grounds" (Pet. App. 19a), it concluded that the "literal words" of Section 801 compelled the attribution of the A&H reserves to the issuing company under the Treaty I-type arrangement. But as we have demonstrated in Part B, *supra,* pp. 37–41, the language of the statute shows that the accident and health reserves are includable in the taxpayers' "total reserves." [16]

The fundamental error of the Court of Claims' ruling that the A&H reserves were attributable to the issuing company in the Treaty I-type arrangements was to confuse the concept of "unearned premium reserve" with the unearned premiums themselves. While they are equal in amount, they are entirely different items on an insurance company's balance sheet. The unearned premium reserve represents the potential liability to the policyholders and can therefore only be attributed to the company that bears the liability, *viz.,* the reinsurer of the risk. However, the unearned premiums are the amount of premiums collected that are allocable to periods of future coverage.[17]

[16] In Part E, *infra*, pp. 66–75, we discuss whether the other companies with which the taxpayers contracted were required by state law to establish the A&H reserves so as to fit within the statutory category "all other insurance reserves required by law" (Section 801(c)(3)).

[17] In No. 75–1285 (*Penn Security*), the Court of Claims demonstrated that it viewed the premium dollars as the reserves by citing

A company that simply holds "unearned premiums" on behalf of another company until they are "earned" cannot include the equivalent amount in a reserve for "unearned premiums" under Section 801(c)(2) unless it has the ultimate liability to meet policyholder claims.[18] Since Consumer Life was ultimately liable under Treaty I to meet such claims, the "unearned

with approval the statement of Arthur Crooks Eddy (who testified as an expert for the taxpayers in all of these cases) that the liability for an unearned premium reserve "depends on whether you've got the money or not * * *" (Pet. App. 44a). But that would be equally true in the case of a company that makes time deposits with a bank equal to the amount of premiums it receives. In such a case, the bank, to use Mr. Eddy's phrase "has got the money," but it could hardly be contended that the company would not have to maintain the reserve. It should make no difference where, as here, the "bank" is another insurance company.

[18] In support of its holding in *Penn Security*, the Court of Claims (Pet. App. 13a) relied upon Treasury Regulations (26 C.F.R.), Section 1.801–3(e), which defines "unearned premiums" as "those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance." Focusing upon the advance payment characteristic of "unearned premiums," the court concluded that the taxpayer did not receive "unearned premiums" because under the Treaty I-type arrangement the monthly reinsurance premiums were payable only after they had been earned by the taxpayer. But this reasoning similarly confuses the unearned premiums themselves with the unearned premiums reserves, which is the relevant factor for purposes of the reserve ratio test. Moreover, the court appears to have overlooked the Regulation's reference to the "cost of carrying the insurance risk * * *." Since the taxpayers undertook under the Treaty I-type arrangements to reimburse the issuing company for all claims paid, it can hardly be said that the issuing company bore the "cost of carrying the insurance risk" for any period, much less "the period for which the premiums have been paid in advance."

premiums" are attributable to it for purposes of the Section 801 reserve ratio test.[19]

Like the Court of Claims in Nos. 75–1221 (*Consumer Life*) and 75–1285 (*Penn Security*), the dissenting opinion of then Judge Stevens in *Economy Finance Corp.* v. *United States, supra,* 501 F. 2d at 483–486, argued that the A&H premium dollars were

[19] The fact that the Court of Claims concluded that the taxpayers were not required under Georgia, Arizona, or Missouri law to establish a reserve for the A&H policies (see Part E *infra*, pp. 66–75) does not weaken our argument that the economic reality and the statutory language require the inclusion of these reserves under Section 801(c)(2). By explicitly providing that the term "unearned premiums" "includes all unearned premiums, whether or not required by law," Treasury Regulations (26 C.F.R.) Section 1.801–3(e) confirms that Section 801(c)(2) does not turn upon state law requirements.

Indeed, in the life insurance area, this Court has repeatedly held that state insurance statutes or regulatory administrative practices do not control the question whether certain reserves are "life insurance reserves" for federal tax purposes even though they were required under state law. See, *e.g.*, *McCoach* v. *Insurance Co. of North America*, 244 U.S. 585, 589 (reserve for unpaid losses); *New York Life Ins. Co.* v. *Edwards*, 271 U.S. 109, 119 (reserve for unreported losses); *Helvering* v. *Illinois Ins. Co.*, 299 U.S. 88, 90–91 (reserve to meet obligation to provide a tontine fund). As the Seventh Circuit correctly observed in *Economy Finance Corp.* v. *United States, supra*, 501 F. 2d at 478–479, in the context of a Treaty I-type arrangement, "[t]he fact that the state insurance authorities required or permitted [the issuing company] to hold the reserve for solvency purposes does not answer the question of whose business the reserves measure." Likewise, in No. 75–1260 (*First Railroad*), where the taxpayer appears to have conceded the point (A. 125–126), the court of appeals stated with respect to a Treaty II-type arrangement, "[t]he fact that the state insurance authorities permitted the 'reserves' to be handled as done by Insurer and Reinsurer cannot overcome these economic realities" (Pet. App. A 5a, n. 8).

only paid over to the reinsurer after they were "earned" and "only as those premiums were earned, did [the issuing company] use those funds to purchase reinsurance from the taxpayers" (*id.* at 484). However, such an analysis is inconsistent with the undisputed reinsurance aspects of the transaction: there would hardly be any need for the issuing company to reinsure a risk with respect to a period that had already expired. Thus, the substance of the agreement, as the majority there concluded, was that the entire A&H risk was assumed by the reinsurer at the very outset of the arrangement and that the issuing company retained a small commission for administrative services.

Finally, the dissent suggested (*id.* at 486, n. 7) that the government's position "would lead to the disqualification of any company writing nothing but term life insurance." (See also No. 75–1285—Pet. App. 18a). But such a company would undoubtedly receive premiums and establish reserves to meet policyholder claims that would qualify as "life insurance reserves" as that term is defined in Section 801(b). Indeed, while Congress might have regarded term life insurance as different from ordinary life insurance, the Court of Claims has held that it did not do so. See *Alinco Life Insurance Co.* v. *United States, supra.*[20]

[20] The dissent in *Economy Finance* further argued that the reinsurer had not fully assumed the A&H risk because the termination provisions of the treaty only imposed an assumption of 10 percent of the risk (501 F. 2d at 484–485). While we agree with the majority's conclusion in that case that the termination provi-

2. *Treaty II.* Pursuant to Treaty II, the roles of respondent Consumer Life and American Bankers were purportedly reversed. Consumer Life became the primary insurer of the credit life and A&H policies and American Bankers agreed to reinsure 80 percent of the liability under each A&H policy (but none of the life insurance) issued by Consumer Life (Pet. App. B 72a–73a, 99a).

Treaty II provided that Consumer Life would remit quarterly to American Bankers the premiums collected on the ceded 80 percent share of the A&H coverage, less its own tentative "commission" of 50 percent. The agreement further provided that American Bankers would return to Consumer Life a quarterly rebate or "experience refund" equal to the total premiums allocable to the quarter, less the sum of: (1) the 50 percent tentative commission previously retained by Consumer Life, (2) three percent of the gross premiums allocable to the quarter, and (3) all claims paid by American Bankers during the quarter. If the sum of these three reductions exceeded the premiums for any quarter, the excess would be carried over to the succeeding quarter and charged against

sions lacked economic reality because it was unlikely that the reinsurer would assume 10 percent of the risk without any further consideration (*id.* at 478), there was no comparable termination provision in the parallel Treaty I arrangements involved in *Consumer Life* and the Pilot and National Fidelity treaties in *Penn Security*. In these cases, in the event of termination, the treaty would continue to apply to all policies reinsured under the agreement prior to termination (see No. 75–1221—Pet. App. B 117a; No. 75–1285—Pet. App. 42a).

the experience refund for that quarter (Pet. App. B 72a–74a, 120a–121a).

After approximately two years of operation, the parties amended Treaty II to provide that any negative carry-forward arising from loss experience for a particular quarter would be dropped after 20 quarters, if it was not absorbed by that time (Pet. App. A 47a).[21]

Treaty II did not provide for any reinsurance because Consumer Life did not transfer any insurance risk to American Bankers. After issuing the policies, Consumer Life purported to "reinsure" them with American Bankers under an agreement called a "reinsurance treaty." But in addition to Consumer Life's initial retention of 50 percent of the A&H premiums as a commission, American Bankers was required to pay over to Consumer Life 47 percent of the premiums after deduction of claims paid. Thus, Consumer Life bore the entire risk of loss on the A&H business and paid American Bankers a commission that could

[21] Treaty II is essentially identical to the treaty involved in No. 75–1260 (*First Railroad*). There, the agreement provided that Georgia Insurance, the counterpart to American Bankers, would not ultimately bear any losses and would receive neither more nor less than its four percent commission (see Pet. App. A 4a). However, unlike Treaty II, there was no immediate tentative "ceding commission" paid to the direct insurer in *First Railroad*. Moreover, it is unclear whether the direct insurer in *First Railroad* ever actually transferred any funds to Georgia Insurance in excess of its four percent commission. The transfers to Georgia Insurance and its return of the "ceding commission" to Georgia Life appear to have been accomplished by "accrual accounting" (see No. 75–1260—A. 71).

216-901—76——6

not exceed three percent for holding the premiums and paying the claims (Pet. App. B 74a).

As was the case under Treaty I, American Bankers functioned as a paymaster or commision agent, not an insurer. For the reason we have set forth in our analysis of Treaty I (*supra*, pp. 52–61), the A&H reserves were therefore attributable to Consumer Life and not to American Bankers.

Indeed, American Bankers' commission was never meaningfully put to any risk. Under the initial version of Treaty II, American Bankers could carry forward any loss in excess of 50 percent of premiums and reduce Consumer Life's "experience refund" for the succeeding quarter. The loss-carry-forward procedure was subsequently limited to losses for more than five consecutive years.

The practical effect of the arrangement was that American Bankers would in all events receive neither more nor less than its three percent commission and would incur no loss unless the claims exceeded 47 percent of premiums for more than five consecutive years. However, the loss experience on A&H policies under the initial version of Treaty II was 18 percent of premiums paid.[22] The trial judge was therefore amply justified in finding that the likelihood that the loss experience would run so high as to jeopardize American Bankers' commission was "so

[22] In No. 75–1260 (*First Railroad*), the claims averaged only about 22 percent of the premiums (Pet. App. A 4a).

remote as to be negligible, and the parties knew this" (Pet. App. A 48a).[23]

In determining tax consequences, the courts are not bound by remote hypothetical contingencies that are at odds with the practical realities and substance underlying a transaction. See, *e.g.*, *Jones* v. *United States*, 531 F. 2d 1343 (C.A. 6); *Kinsey* v. *Commissioner*, 477 F. 2d 1058, 1063 (C.A. 2). "Figures speak and when they do, Courts listen." *United States* v. *Jackson Oldsmobile, Inc.*, 371 F. 2d 808, 809 (C.A. 5) (Brown, J., concurring). The figures in these cases eloquently testify to the fact that the Treaty II-type arrangements were an elaborate facade of hypothetical and speculative risk-shifting behind which the so-called "reinsurance company" bore no risk of loss and served in the selfsame paymaster capacity as American Bankers under Treaty I. For all practical purposes, American Bankers had no stake in the A&H business except to the extent of its three percent commission which it received under all foreseeable circumstances.

As the Fifth Circuit succinctly stated in No. 75–1260 (*First Railroad*) with respect to an arrangment identical to Treaty II: "Reinsurer under the arrangement did not bear any risks except the outside possibility of

[23] In No. 75–1260 (*First Railroad*), even the district court, which upheld the taxpayer's position with respect to a Treaty II-type arrangement, conceded that "the risk of loss upon Georgia Insurance was, in actuality, remote" (Pet. App. B 14a).

insolvency of Insurer. We hold therefore there was no substance to the agreement as reinsurance" (footnote omitted) (Pet. App. A 4a–5a). The lack of substance as reinsurance of Treaty II and its counterpart in *First Railroad* demonstrates that neither Consumer Life nor Georgia Life were eligible for "life insurance company" status while those agreements were in force.

E. THE APPLICABLE STATE LAW CONFIRMS THAT THE ACCIDENT AND HEALTH INSURANCE RESERVES ARE INCLUDABLE IN TAXPAYERS' TOTAL RESERVES

While our analysis has proceeded in the first instance upon the language and history of Section 801, it is also confirmed by the applicable state insurance law to which these transactions were subject. Pursuant to these statutes, the taxpayers were required to maintain and establish accident and health reserves under both the Treaty I and II-type arrangements. Thus, the state statutes lend additional support to the proposition that for purposes of Section 801(c)(2), the unearned premiums reserve for non-life coverage must be attributed to the company that bears the risk.

Moreover, this state law is explicitly applicable to the third element of the statutory definition of "total reserves," as set forth in Section 801(c)(3), *i.e.*, "all other insurance reserves required by law." Pursuant to Treaty Regulations (26 C.F.R.), Section 1.801–5 (b), the term "reserves required by law" means "reserves which are required either by express statutory provisions or by rules and regulations of the insurance

department of a State * * *." Thus, if the applicable state insurance statutes required the taxpayers to establish reserves for the A&H coverage on which they bore the ultimate insurance risk, the A&H reserves would also be includable in the taxpayers' "total reserves" as "other insurance reserves required by law" under Section 801(c)(3).

In rejecting the force of the applicable state law in Nos. 75–1221 (*Consumer Life*) and 75–1285 (*Penn Security*), the Court of Claims relied in part upon the fact that neither the Georgia, Arizona, nor Missouri state insurance authorities took any action against the taxpayers' failure to establish such A&H reserves for state reporting purposes (See No. 75–1221—Pet. App. A 86a–91a; No. 75–1285—Pet. App. 21a–22a). But the state insurance officials' failure to require the taxpayers to establish A&H reserves can hardly be dispositive of the question whether these reserves were "required by [state] law" under Section 801(c)(3).

Indeed, in applying substantive federal tax statutes that are based upon state law, as well as in diversity actions, this Court has disregarded the decisions of state trial and even intermediate appellate courts, in the absence of a ruling of the highest court of the state, when it has concluded that the highest court of the state would have decided otherwise. See *Commissioner* v. *Estate of Bosch*, 387 U.S. 456, 464–465; *King* v. *Order of Travelers*, 333 U.S. 153, 160–161; *West* v. *A. T. & T. Co.*, 311 U.S. 223, 227. The error of the Court of Claims' reliance upon the non-action by state

administrative officials follows *a fortiori* from these decisions.

1. There are no decisions of the states' highest courts, or indeed of any state courts, as to whether the taxpayers were required to establish A&H reserves under state law. But any reliance upon the lack of state administrative action against the taxpayers is particularly unjustified in the face of the uncontradicted testimony of the state insurance officials in two of the three cases (*Consumer Life* and *First Railroad*) that their failure to require inclusion of the A&H reserves on the taxpayers' annual statements was a consequence of their unfamiliarity with the substance of the arrangements.

In *Consumer Life,* the Georgia chief insurance examiner testified that Consumer Life's omission of A&H unearned premium reserves from its annual statement was permitted "unwittingly" (A. 239) and was in fact contrary to that state's policy (A. 211–213, 215, 221–226, 232–233, 240, 241–242, 256–259).[24] Similarly, the Arizona examiner who had conducted Consumer Life's triennial examination for that state in 1963 testified that it should have been required to maintain the reserves under Treaty II, but had been

[24] The Georgia official also testified that under Treaty I, Consumer Life should have included the A&H premiums as an asset and established the unearned premium reserve as an offsetting liability to reflect its ultimate obligations under the A&H policies. He further explained that American Bankers should have included the premiums received in its assets as "cash" and included a liability for "[re]insurance premiums owed" (rather than an "unearned premium reserve") (A. 256–258).

permitted to exclude the A&H coverage from its reserves because it was the first time that the Arizona insurance commissioner had encountered that type of arrangement (A. 260, 263–268). Finally, in *First Railroad,* the Georgia examiner testified that the 1967 Georgia insurance examination report, which stated without elaboration that the reinsurance contract appeared to be in good order was "contrary to all reporting standards and practice" (A. 148) and had neither been accepted nor disapproved by the Georgia Department of Insurance (A. 146–149).

2. The foregoing testimony of the state insurance officials in *Consumer Life* and *First Railroad* is confirmed by the language of the relevant state statutes in all three cases.

Arizona, Georgia, and Missouri law are respectively applicable to *Consumer Life, First Railroad* and *Penn Security.* Pursuant to the law of these states, every "insurer" of accident and health policies is required to maintain reserves on all policies in force on a gross unearned premiums basis. See Ariz. Rev. Stat. Ann., § 20–506 (1956) (No. 75–1221—Pet. App. A. 84a); Georgia Code Ann., §§ 56–906 and 56–908 (1935) (No. 75–1221—Pet. App. A. 51a–53a); Ann. Mo. Stat., § 376.410 (1968). An "insurer" is generally defined as an "indemnitor" or person in the business of contracting to indemnify another. See Ariz. Rev. Stat. Ann., §§ 20–103 and 20–104 (1956); Georgia Code Ann., §§ 56–102 and 56–103 (1935).

The significant aspect of these state statutes is that they require the establishment of a reserve by the

company that is ultimately liable to meet policy claims whether or not it has actually received the premiums for the coverage. Thus, under state law, the company whose net worth will be affected by the payment of the claims must reflect that liability on its annual statements by setting up a reserve. Since the taxpayer companies in all three cases either contracted to indemnify the issuing companies or issued the A&H policies themselves, they were the "insurers" of the risks under these state statutes and were required to maintain the A&H reserves.

The existence of the requirement under state law that a company establish a reserve upon its assumption of a risk without regard to its receipt of premiums is demonstrated by the statutory definition of "assets" applicable in these cases. Thus, Ariz. Rev. Stat. Ann., § 20–501(5), (7) and (9) (1956) respectively include in "assets" the following categories (see No. 75–1221—Pet. App. A 53a–54a):

> (5) Premiums in the course of collection other than for life insurance, not more than three months past due, less commissions payable thereon. The foregoing limitation shall not apply to premiums payable directly or indirectly by the United States or by any of its instrumentalities.
>
> (7) Notes and like written obligations not past due, taken for premiums other than life insurance premiums, on policies permitted to be issued on such basis, *to the extent of the unearned premium reserves carried thereon.*

> (9) Amounts receivable by an assuming insurer representing funds withheld by a solvent ceding insurer under a reinsurance treaty [emphasis supplied].

Accord: Georgia Code Ann., § 56–901(6), (8) and (10) (1935) (No. 75–1221—Pet. App. A 50a).

These broad statutory definitions of "assets" demonstrate the error of the Court of Claims' statement in *Consumer Life* that the statute requiring the establishment of reserves for the A&H coverage "implies that there were corresponding assets in the first place" (No. 75–1221—Pet. App. A 83a–84a). Paragraph (5) refers to "[p]remiums in the course of collection"; paragraph (7) refers to "notes and like written obligations not past due * * * to the extent of the unearned premium reserves carried thereon"; and paragraph (9) refers to "amounts receivable by an assuming insurer * * * under a reinsurance treaty."[25] These categories of "assets" do not represent premiums paid in hand. Indeed, the reference in paragraph (7)—"to the extent of the unearned premium reserves carried thereon"—proves that the applicable state law contemplates the establishment of the reserve even prior

[25] In *Consumer Life*, the Court of Claims concluded that the Georgia and Arizona definitions of "assets" were limited to "amounts already due and unpaid" (No. 75–1221—Pet. App. B 83a). But paragraph (7) specifically refers to obligations "not past due" taken for premiums, and paragraph (9) speaks of amounts withheld by a ceding insurer "under" a reinsurance treaty. Thus, the language of the statutes themselves refutes the restrictive gloss imposed upon them by the Court of Claims.

to the time when the right to receive the premiums becomes fixed.[26]

Thus, under these prototype state insurance statutes there is no matching principle that a reserve can only be established if there is a corresponding asset. To the contrary, it is the assumed obligation to the policyholder that triggers the requirement of a reserve.[27] But see *Economy Finance Corp.* v. *United States, supra,* 501 F.2d at 485, n. 5 (Stevens, J., dissenting).

a. *Treaty I-type arrangements.* The Treaty I-type arrangement was employed in *Consumer Life* and *Penn Security.* As we have pointed out *supra,* under Arizona law, which is applicable to Consumer Life, an insurance company that assumes the risk under non-life coverage is an "insurer" and is required to establish a reserve, even prior to its actual receipt of the premiums. Since Consumer Life reinsured the risk of the A&H coverage under Treaty I, it was required to establish a reserve corresponding to that risk.

[26] Indeed, Arthur Crooks Eddy, taxpayers' expert witness in *Consumer Life*, acknowledged under questioning by the trial judge that the critical reason for the establishment of the reserve is the responsibility to pay the claims "[i]rrespective of how the premiums are handled and whose [*sic*] holding them" (No. 75–1221—A. 130).

[27] For the generally accepted insurance accounting treatment under the Treaty I-type arrangement, see Hammond, *supra, Insurance Accounting Fire and Casualty*, pp. 142–143. That text states that the assuming reinsurer (the taxpayers) must account for the reinsurance transaction exactly as if it had actually received the premiums from the ceding company. The only difference is that the reinsurer adds the premiums to an asset account entitled "Funds Held By or Deposited With Ceding Reinsurers", instead of to its cash account. See p. 13, n. 4, *supra.*

The Missouri statutes applicable in *Penn Security* are to the same effect. Ann. Mo. Stat., § 376.410 (1968), requires that all companies engaged in writing accident and health insurance "shall maintain reserves thereon" and paragraph (4) provides that "proper credit shall be allowed for reinsurance in other companies licensed to do business in this state." The clear import of this statute is that under a bona fide reinsurance agreement, such as in *Penn Security,* Missouri law permits the ceding company to reduce its reserves and requires the reinsurer to increase its reserves in an amount corresponding to the reinsured coverage.[28] Since *Penn Security* reinsured the risk, it was likewise required to establish a reserve.

b. *The Treaty II-type arrangement.* The Treaty II arrangements are involved in both *Consumer Life* and *First Railroad,* with respect to which Arizona

[28] In rejecting the argument that the Missouri statutes required the inclusion of the A&H reserves in the taxpayer's reserves, the Court of Claims relied upon the inaction of the Missouri administrators and the testimony of the taxpayer's expert witness, Arthur Crooks Eddy, that "no state regulatory authority would impose an unearned premiums reserve requirement where * * * such company did not receive premiums for insurance to be provided in the future" ((No. 75–1221) Pet. App. 48a–49a; see also A. 236; (No. 75–1285) Pet. App. 21a–22a and n. 4). However, the witness failed to consider Ann. Mo. Stat. § 375.246 (1968), which provides that no reduction from reserves is to be allowed "under which the assuming insurer bears no substantial insurance risk or substantial risk of net loss to itself." It is therefore plain that the Missouri statute imposes a reserve requirement on the issuing company where, as in Treaty II-type arrangements, the "reinsurer" does not assume the insurance risk and the issuing company does not receive the premiums until after they are earned.

and Georgia law are applicable. Under the statutes of those states, the ceding company under a reinsurance arrangement is entitled to reduce its reserves when it has reinsured risks with another qualified company. See, *e.g.*, Georgia Code Ann., §§ 56–413 and 56–906 (1935); and Ariz. Rev. Stat. Ann., §§ 20–261 and 20–506 (1956). But the reduction of reserves by the issuing company contemplated by these statutes is for bona fide reinsurance contracts and not for the elaborate Treaty II-type arrangements under which the so-called "reinsurer" bore no risk at all.[29]

Indeed, when an insurance company cedes insurance to a company that is not licensed to do business in the state, a transaction that is a relatively common occurrence, the state will not permit the ceding company to reduce its reserves. From the standpoint of the state authorities, no transfer of risk has occurred. See, *e.g.*, Ariz. Rev. Stat. Ann., § 20–261 (1956), and Georgia Code Ann., § 56–413(3) (1935). It would follow *a fortiori* that the ceding company could not reduce its reserves in a Treaty II-type arrangement, where no risk is in fact transferred.[30]

In sum, the state statutes must be viewed against the background of the settled definition of "reinsurance," as provided by the National Association of Insurance Commissioners in its *Examiners Handbook, supra,* which the state examiners generally follow as a guide in performing their audit functions (see 75–1221–A. 193). The Handbook states (p. B6, No. 75–1260, A. 211):

> The essential element of every true reinsurance contract is the undertaking by the reinsurer to indemnify the ceding insurer, not only in form but in fact, against loss or liability by reason of the original insurance. *Unless the so-called reinsurance contract contains this essential element, no credit whatsoever shall be allowed on account thereof in any accounting or financial statement of the ceding insurer* [emphasis supplied].

Since the taxpayers under the Treaty II-type arrangements were the issuing companies and could not reduce their reserves by the A&H coverage they wrote because they did not part with the risk, the applicable state law is in accord with the general rule that we urge in these cases, *viz.*, that the insurance reserves follow the insurance risk.

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[29] See also Ann., Mo. Stat. § 375.246 (1968), described at p. 73, n. 28, *supra*, which specifically forbids the issuing company to reduce its reserves in a Treaty II-type arrangement.

[30] Even if the Treaty II-type arrangements actually had shifted a significant insurance risk to the reinsurers with respect to claims in excess of ceded premiums, the taxpayers would not be entitled to reduce their own unearned premium reserves. Under such "excess loss" or "stop loss" agreements, pursuant to which reinsurer assumes the risk of such losses beyond a stated portion of gross premiums (rather than a quota share of all losses), the ceding company must continue to retain the reserve for unearned premiums because it bears the ultimate impact of claims to the extent of such unearned premiums. See Reinarz, *Property and Liability Reinsurance Management* (1969 ed.) pp. 72–73, 81.

CONCLUSION

For the reasons stated, the judgments of the Court of Claims in Nos. 75–1221 (*Consumer Life*) and 75–1285 (*Penn Security*) should be reversed and the judgment of the court of appeals in No. 75–1260 (*First Railroad*) should be affirmed.

Respectfully submitted.

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